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3M Company (MMM) CEO Michael Roman on Q1 2019 Results - Earnings Call Transcript

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Q1: 04-25-19 Earnings Summary

Press Release SEC *10-Q* *Slides*

EPS of $2.23 misses by $-0.27 | Revenue of $7.86B (-5.01% Y/Y) misses by $-161.97M

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3M Company (NYSE:MMM) Q1 2019 Results Earnings Conference Call April 25, 2019 9:00 AM ET

Company Participants

Bruce Jermeland - Vice President, Investor Relations

Michael Roman - Chief Executive Officer

Nicholas Gangestad - Senior Vice President, Chief Financial Officer

Conference Call Participants

Andrew Obin - Bank of America

Joe Ritchie - Goldman Sachs

Andrew Kaplowitz - Citi

John Inch - Gordon Haskett

Julian Mitchell - Barclays

Josh Pokrzywinski - Morgan Stanley

Deane Dray - RBC Capital Markets

Scott Davis - Melius Research

Laurence Alexander - Jefferies

Steve Tusa - JPMorgan

Nigel Coe - Wolfe Research

John Walsh - Credit Suisse

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the 3M First Quarter Earnings Conference Call. During the presentation, all participants will be in a listen-only mode. Afterwards we will conduct a question-and-answer session. [Operator Instructions] As a reminder, this conference is being recorded Thursday, April 25, 2019.

I would now like to turn the call over to Bruce Jermeland, Vice President of Investor Relations at 3M.

Bruce Jermeland

Thank you and good morning everyone. Welcome to our first quarter 2019 business review. With me today are Mike Roman, 3M's Chief Executive Officer, and Nick Gangestad, our Chief Financial Officer. Mike and Nick will make some formal comments and then we'll take your questions.

Please note that today's earnings release and slide presentation accompanying this call are posted on our Investor Relations website at 3m.com under the heading, Quarterly Earnings. Please turn to Slide 2.

Before we begin, let me remind you to mark your calendars for upcoming earnings calls on July 25, and October 24.

Please take a moment to read the forward-looking statement on Slide 3. During today's conference call, we will make certain predictive statements that reflect our current views about 3M's future performance and financial results. These statements are based on certain assumptions and expectations of future events that are subject to risks and uncertainties. Item 1a of our most recent Form 10-K lists some of the most important risk factors that could cause actual results to differ from our predictions.

Finally, please note that throughout today's presentation, we will be making references to certain non-GAAP financial measures. In particular measures which exclude the impact of the Tax Cuts and Jobs Act and significant litigation-related charges. Reconciliations of the non-GAAP measures can be found in the appendix of today's presentation and press release.

Please turn to Slide 4, and I'll hand it off to Mike. Mike?

Michael Roman

Thank you, Bruce. Good morning everyone and thank you for joining us. The first quarter was a disappointing start to the year for 3M. We continued to face slowing in several key end markets, which impacted both growth and margins, and our operational execution fell short of the expectations we have for ourselves.

Today I will lay out a number of aggressive actions we are taking to drive productivity, reduce costs and improve cash flow, as we manage through challenges in some of our end markets.

In addition, I will provide an update on two litigation issues that affect affected our results. And provide updated guidance for the full year. I will also discuss the realignment of our business groups that we announced last month which will enable even greater growth and operational efficiency.

Please turn to slide 5 for a summary of our first quarter numbers. Organic growth company-wide was minus 1%, lower than we anticipated. We saw end market softness in China, Automotive and Electronics, which we have discussed throughout the quarter.

We also faced channel inventory adjustments, which negatively impacted several of our businesses. With respect to EPS, we posted adjusted earnings of $2.23 per share down 11% year-over-year. This excludes significant litigation charges related to the PFAS and respirators, which I will discuss later in my remarks.

Underlying margins were 21% in the quarter, down 160 basis points with adjusted income of $1.7 billion. Our earnings and margin shortfall was due to a combination of two things.

First negative organic growth in the quarter and the second weak productivity, especially in our Industrial related businesses within Asia Pacific and the United States. As the actions we took were not sufficient to offset the broad-based softening we faced in those markets as the quarter progressed.

Please turn to slide 6. We are moving quickly to strengthen our performance and address the challenges we face and the actions on this slide are underway. First, we are reducing approximately 2,000 positions, through both voluntary and involuntary actions. Reductions will span all business groups, functions and geographies with emphasis on corporate structure and underperforming areas of the portfolio.

On a pre-tax basis we will take a charge of approximately $150 million in 2019, and we expect annual savings of approximately $225 million to $250 million, with $100 million this year.

Job reductions are never easy, but they are necessary to make us stronger and a more competitive enterprise as we move forward.

Beyond restructuring, we are also driving cash flow by reducing inventory levels and accelerating actions on indirect costs. Importantly, while we take these actions we remain focused on our customers and balancing short term pressures with the long-term success of 3M.

That is why we will continue our investments in growth, which includes research and development and our priority growth programs. This is a playbook we know how to execute and we are confident it will enable us to maximize value for shareholders as we work through the market slowdowns and our related actions, positioning us for strong growth as our markets recover.

Please turn to slide 7. As I mentioned earlier, two significant litigation matters related to PFAS and respirators impacted our quarter and resulted in a total charge of $548 million or $0.72 per share. We increased our respiratory reserve by $313 million to address the costs of resolving all current and expected: coal mine dust lawsuits in Kentucky and West Virginia.

We also established a PFAS reserve of $235 million to cover certain environmental matters and litigation related to the manufacture and disposal of PFAS at five 3M facilities, including three in the United States and two in Europe. This reserve does not include any product claims related to PFAS.

We continue to work closely with the EPA and other regulatory bodies to support science-based regulations of these chemistries. We also continue to work with the communities we serve to ensure they can have confidence in the quality of their drinking water, additional details will be available in our upcoming 10-Q filing.

Please turn to slide 8 for an update on our 2019 guidance. While we remain positive on the global macroeconomic environment, growth conditions in certain markets have been slower than anticipated going into the year. As a result, today we are updating our range for organic growth to minus one to the top plus 2%, against the prior range of one 1% to 4%.

In addition, we anticipate adjusted earnings of $9.25 to $9.75 per share which includes the restructuring impact versus the previous range of $10.45 to $10.90. We now expect a return on invested capital of 20% to 22% against the prior range of 22$ to 25%.

We continue to anticipate a free cash flow conversion rate of 95% to 105%. I'll come back to make some comments on our new business group alignment after Nick takes you through the details of the quarter. Nick

Nicholas Gangestad

Thank you, Mike and good morning, everyone. Please turn to slide 9. Organic sales declined 1.1% in the first quarter, with volumes down 200 basis points and selling prices up 90 basis points. The net impact of acquisitions and divestitures reduced sales by 50 basis points. While foreign currency translation was an additional 3.4 percentage point headwind to sales.

All-in, first quarter sales in U.S. dollars decreased 5% versus last year. Geographically the U.S. declined 40 basis points organically, Consumer and Electronics and Energy grew low-single digits, while Industrial, Safety and Graphics and Health Care declined.

Asia Pacific was down 3.6% organically in Q1, impacted by the slowdown in China, Automotive and Electronics markets. Health Care delivered positive high single-digit organic growth in the quarter, while Industrial, Consumer and Electronics and Energy declined.

Organic growth was down 4% in China/Hong Kong against an 11% comparison a year ago. Japan organic growth declined 7%, or excluding Electronics increased 2%. Latin America/Canada and EMEA each grew 1% organically in the quarter.

Please turn to slide 10 for the first quarter P&L highlights. Company-wide first quarter sales were $7.9 billion, with adjusted operating income of $1.7 billion and adjusted operating margins of 21.4%.

On the right-hand side of this slide, you can see the components of our margin performance in the first quarter. Declines in organic volume and weak productivity reduced margins 180 basis points year-on-year.

Productivity challenges were most pronounced in our Industrial related businesses within Asia Pacific and the United States. Acquisitions and divestitures combined brought down margins by 40 basis points, primarily driven by our acquisition of M*Modal which closed in February.

Higher selling prices continued to more than offset raw material inflation contributing 30 basis points to first quarter margins. And finally, foreign currency net of hedging impacts increased margins by an additional 30 basis points.

Let's now turn to slide 11 for a closer look at earnings per share. First quarter adjusted earnings were $2.23 per share, down 11% year-over-year. As you see, a number of factors impacted first quarter earnings. Most significantly, negative organic growth and weak productivity reduced per share earnings by $0.19 in the quarter. This was notably different from our outlook in January. The rest of our EPS factors are in line with our original expectations.

Acquisitions and divestitures combined reduced first quarter earnings by $0.07 per share versus last year. Foreign currency net of hedging was an additional $0.05 per share headwind in the quarter. As expected, our underlying tax rate increased year-on-year, which reduced Q1 earnings $by $0.05. And finally, we reduced average diluted shares outstanding 4% versus Q1 last year, adding $0.09 to per share earnings.

Please turn to slide 12 for a look at our cash flow performance. First quarter free cash flow was $657 million, with a free cash flow conversion rate of 74%, which includes a 24 percentage point benefit from the litigation-related charges.

First quarter capital expenditures were $391 million, up $87 million year-on-year. For the full year, we now anticipate CapEx investments in the range of 1.6 billion to $1.7 billion versus a prior range of $1.7 billion to $1.9 billion.

We increased our first quarter per share dividend by 6%, resulting in $830 million in cash dividends paid to shareholders during the quarter. Gross share repurchases were $701 million in the quarter, and we continue to expect full year repurchases in the range of $2 billion to $4 billion.

Please turn to slide 13, where I will summarize the business group performance for Q1. Please note additional business group performance details can be found in the appendix of this presentation.

As mentioned earlier, throughout the quarter we continued to see soft end market trends in China, Automotive and Electronics, along with channel inventory adjustments. These trends primarily impacted our Industrial, Safety and Graphics, and Electronics and Energy businesses.

Our Industrial business saw a broad-based slowdown across most of its portfolio, posting an organic sales decline of 2.8% to start the year. This slow organic growth within Industrial was most pronounced in our automotive business.

Our automotive OEM business was down 9% year-on-year, impacted by a 6% decline in first quarter global car and light truck builds, along with channel inventory reductions, particularly in China.

A positive note, advanced materials continued to deliver strong organic growth in the quarter, up high single digits.

On a geographic basis Industrial's organic growth was led by 1% increases in both Latin America/Canada and EMEA, while the U.S. declined 2% and Asia Pacific declined 8%. Industrial's first quarter operating margins were 20%, down 280 basis points, impacted by sales declines and weak productivity.

Moving to Safety and Graphics, first quarter sales were flat organically against last year's 7% comparison. Personal Safety continued to deliver solid results in Q1, up 3% organically, while each of the other three businesses declined. Geographically, organic growth was led by Latin America/Canada and EMEA, each up 2%. Asia Pacific was flat, while the U.S. was down 3%.

Safety and Graphics first quarter operating margins were 23.2%, down 380 basis points. The year-on-year operating margin decline included a negative 110 basis point impact from a gain on a divestiture last year, along with slow growth and weak productivity.

Next our Health Care business was up 1% organically in the first quarter. Holding back growth in Health Care was the continued softness in our drug delivery business, down nearly 20% organically in the first quarter, which negatively impacted overall Health Care organic growth by nearly 2 percentage points.

Organic growth was led by food safety, up high single digits followed by health information systems up mid-single digits, while medical solutions and oral care were each up low-single digits organically.

On a geographic basis, Asia Pacific led the way up 7%, with EMEA up 3%. The U.S. declined 3% impacted by drug delivery. Health Care's first quarter operating margins were 28.1% which included a negative 230 basis point impact from the Q1 acquisition of M*Modal.

Shifting to the Electronics and Energy business, organic sales declined 3% in the first quarter. The Energy side of the business grew 5%, while the Electronics related businesses were down 6%, with declines in both display material systems and Electronics material solutions.

Electronics related growth was impacted by soft end market demand in Consumer Electronics and factory automation, along with channel inventory adjustments. On a geographic basis, organic growth was led by a 2% increase in the U.S., while Asia Pacific declined 5%. First quarter operating margins were 23.8%, down 110 basis points year-over-year.

Lastly, first quarter organic growth for the Consumer business was 1%. Sales grew in our home improvement business, up 3% organically, while home care and consumer health care declined.

Looking at Consumer geographically, organic growth was led by a 3% increase in the U.S., with particular strength in our Filtrete and command brands. EMEA declined 1% as we continued to adjust our portfolio in this region and Asia Pacific declined 3% impacted by lower Consumer demand for respiratory solutions. Consumer's operating margins were 19.5% in the first quarter.

That wraps up our review of first quarter results. Please turn to slide 14, and I'll hand it back over to Mike to discuss the business group realignment. Mike?

Michael Roman

Thank you, Nick. Earlier I laid out actions we are taking to address our near-term challenges. At the same time we are continuing to build 3M for the long run. Effective April 1, we moved from five to four business groups in order to better serve our customers and better align our businesses to their markets.

The new business groups are organized around customers and go-to-market models and include Safety and Industrial, Transportation and Electronics, Health Care, and Consumer.

This realignment will enable us to accelerate growth, maximize value across the portfolio, and take greater advantage of our transformation progress. It will also further streamline the organization and help us achieve the 200 to 300 basis points of margin expansion that we laid out last November as part of our five-year plan. We will start reporting results under this structure in the second quarter.

Please turn to slide 15, and I will take you through our 2019 guidance for the new business groups. We expect organic growth to be led by Health Care with a range of 2% to 4%, followed by Consumer at 1% to 3%. Organic growth in Safety & Industrial is expected in the range of minus 1% to plus 2%, with Transportation & Electronics at minus 3% to flat. That wraps up our prepared remarks.

In summary, while our recent performance is disappointing, our business model remains strong and we are making the necessary changes to accelerate 3M into a stronger future. Thank you. And we will now take your questions.

Question-and-Answer Session

Operator

[Operator Instructions] And our first question comes from the line of Andrew Obin of Bank of America. Please proceed with your question.

Andrew Obin

Good morning, guys.

Michael Roman

Morning, Andrew.

Andrew Obin

Just a question on margins. I think the last time you had this kind of revenue decline, as I look at my model was sort of 4Q ‘15 and 1Q ‘16 and sort of the operating leverage impact was a lot less I think in 1Q ‘16 margins actually went up. So I'm just trying to understand what happened with the margin decline in the quarter and specifically also, as I look at the gross margin, what surprised me once again looking at my model, the last time you had gross margins that low I think was 4Q ’08 or 1Q ‘09, so that’s very odd? Thank you.

Michael Roman

Thank you, Andrew. Maybe I'll I start and I'll ask Nick to give some more detailed comments. The two drivers of that, one is the organic growth and the organic growth as we talked about was led by China, Automotive and Electronics, which are strong gross margin businesses for us globally. So that was one of the contributing factors.

And then the adjustments that came in the channel, along with that slowing growth in those markets, that drove challenges for us in productivity in the plants. And we took actions to adjust our production levels and our costs there, but we didn't get ahead of it. So those were a couple of the big contributor really driven off of that slowing the majority of that slowing from those end markets

Nicholas Gangestad

Yes. Andrew, a couple things to add in there. As we were going through the quarter and seeing lower volumes and we of course adjusted the output coming out of our factories. So for the first quarter, compared to the first quarter last year, we were seeing the output in our factories down between 4% and 5%.

Unfortunately we did not pull spending down proportionately. Our spending was down about 1% in our factories during that time. And that had a negative impact on our margin.

Also on the - in there was the impact of a bit of a geographic mix, if you look at where we make higher margins and lower margins, the declines that we saw in Asia Pacific had an outsized impact on our margin this quarter.

Michael Roman

Andrew, I would also add, we - as I said in my speech, we didn't respond aggressively enough to what we were seeing. And so we're behind the curve as we came through the quarter. That's why we're stepping in aggressively with the actions that we are…

Andrew Obin

Let me ask the question maybe another way. We were surprised I think the Asia top line growth was fairly well telegraphed, maybe Japan surprised a little bit, but it's North American decline that also surprised me. And you continued sort of - you did note weak productivity in North America multiple times.

And I was just wondering, how much - and I know we sort of finished the customer-facing ERP rollout. Can you just give us an update? Are you rolling out on the factories your key factories in North America, are you rolling ERP on the manufacturing floor, and is that disruptive? Thank you.

Michael Roman

Andrew, just to update on the ERP, we've actually been very pleased with the success that we've had in the deployment in the U.S., and it has been around the businesses and not deployed to the factory level at this point. It's improving every month in our performance and what we can deliver to our customers. So that's been something that's been going well for us.

When you look at the U.S., the growth, - organic growth in the U.S. was led by Industrial business, and really the automotive OEM and aftermarket businesses. There are some pockets in Safety & Graphics. And so the same kind of comments I had is as we saw slowing growth and some of the channel reactions, our production levels and our productivity didn't get ahead of it, and that was an important part of what we saw in the U.S.

There are some other pockets. There are some pockets in Health Care with drug delivery in the U.S. that also contributed to that. But that gives you the background in the U.S.

Andrew Obin

Okay, thank you.

Operator

Our next question comes from the line of Joe Ritchie of Goldman Sachs. Please proceed with your question.

Joe Ritchie

Thanks. Good morning, everyone.

Michael Roman

Good morning, Joe.

Joe Ritchie

So I'm just thinking about the organic growth guide for the year of minus one to plus two, obviously slower start towards the low end to start the year. I guess, I'm just – as I'm thinking about, how you guys actually get towards that higher end of the range as we progress through the year. I'm just curious like did trends get any better as we exited the quarter? I know comps get tougher as we progress through the year. I'm just trying to like put some context around that guidance for the year?

Nicholas Gangestad

Yes. So Joe maybe I'll start. The – it was led by the markets that we called out and the channel reaction to some of that. That doesn't end up being an all year action. That is something that happens pretty quickly. So we don't see that necessarily be a contributor as we go through the year. And some – we do see some outlook for improvements in those markets.

Health Care we have talked about challenge, we see with drug delivery being a headwind for us in the first half of the year and that gets better as we go through the year. Consumers basically at the bottom end of their range and the sellout remain strong. And in Safety and Graphics, we have a couple of pockets there. Our personnel safety business is off to a strong start to the year. And so up mid-single digits or low- to mid-single digits and we expect that to continue. The other pockets are more project delays in particular businesses and we expect those to improve as we go through the year. So it's really taking a look at each of those businesses and the guidance that we gave to those fits with Q1 and then where we see the rest of the year.

Michael Roman

And Joe on the comp issue consistent with what we've been saying we see second quarter as our toughest comp and third quarter as our easiest comp and that's primarily driven by the what we had talked about a year ago as far as the timing of revenue related to our U.S. ERP go live.

So we saw almost 6% organic growth in second quarter last year followed by 1.3% in the third quarter. So those are the two where we see the comps differentiating. All-in we saw the – we saw and we continue to see the first half as a slightly tougher comp for us than in the second half of the year.

Joe Ritchie

Okay. Got it. That's helpful. And if I could just follow up just on the margins for a second. So taking a look at your gross margins for the quarter. It's hard for me to go back into history and see a time where gross margins were down as much year-over-year.

And Nick you referred to it a little bit when you responded to the lower growth environment in your response from a cost-out perspective at the factory level. I just want to understand that a little bit better because it's just historically this hasn't part of the hallmark of how you guys have executed.

Nicholas Gangestad

Yes Joe. Just one thing I think I need to make sure is clear with you and with everyone. In the gross margin on a GAAP basis is $235 million charge related to PFAS. So in the numbers that you're seeing there on our GAAP results, not all of that hit SG& A other 235 of that is recorded in gross margin. And Andrew that may go back to your earlier question too.

So that's maybe when you're looking at our GAAP results the one thing you're seeing. That said, we still saw declines in our gross margin percentage, primarily driven by what I just talked about at the lower volumes not offset with commensurate declines in spending. Pulling out the PFAS charge we saw are underlying gross margin decline about 100 basis points.

Joe Ritchie

Okay. Thanks for that clarification.

Operator

Our next question comes from the line of Andrew Kaplowitz of Citi. Please proceed with your question.

Andrew Kaplowitz

Hey, good morning, guys.

Michael Roman

Good morning, Andy.

Andrew Kaplowitz

Nick, you mentioned productivity is the issue, a big issue in Industrial in North America and Asia Pacific. If we go back over time industrial has been a segment where 3M has consistently struggled to grow margin and obviously productivity we talked about was worse in Q1. So could you talk about the transformation helping North America?

I know you mentioned it's helping, but it's hard to see. I mean can you talk about your confidence that you can improve productivity in the quarters, especially in North America and Europe where you've talked about an expectation of big margin improvement going forward.

Nicholas Gangestad

Yes. So Andy, when you look at Industrial there's a couple of things around productivity that we're focused on. And the first one is it is getting in line with the growth that we see in the business. And automotive OEM, automotive aftermarket those are challenged end markets that we're especially aggressive getting on top of and in terms of our productivity. But it's more broad than that because -- especially in the U.S. we are a net exporter out of the U.S. and we do support business around the world and in particular in Asia. And so we're impacted by a broader softness in those markets as well.

So it's a bigger productivity challenge in particular in the U.S. but in Industrial more broadly. And so the actions that we're focused on they're targeting that, getting ahead of the curve so to speak. And then it's taking advantage of all the other things that we've talked about the levers for creating greater value. And Business Transformation is a big one of those. Now we haven't deployed that in the U.S. into the plants. But we've made good progress with the go live, since the go live of last year and we continue to see good benefits and value coming out of the ERP deployment in Canada and EMEA.

And our margins more broadly including industrial has been improving there and in part because of what we're doing in Business Transformation. So that's going to be an important lever as we move ahead. But the near term is getting ahead of the impact of the slowing end markets and the channel and getting our productivity in line.

Andrew Kaplowitz

Okay Mike. And maybe shifting gears. Can you talk about the cadence of your business performance through the quarter and what you've seen to the extent that you can talked about in April. Theoretically, there's been more enthusiasm in places like China given an

increase in our tax cuts that could help markets like China auto or electronics. So have you seen any improvements in any of your short cycle businesses over the last few weeks or a month or two?

Nicholas Gangestad

Yes, Andy, certainly as we went through first quarter we talked a bit about the slowing that we saw as it went through the quarter and that continued right through the end of the quarter. And really, led by those markets, China automotive, electronics. So those are all the ones we've been talking about.

There is – I think the outlook is, that gets better. When you listen to the projections and the economic projections in those areas, we haven't seen that. Our April is basically on track with what we're laying out for our total year guidance. But seeing a market improvement in those markets, I think, we'll see – we'll get an answer as we move further into the quarter, into the second quarter.

Andrew Kaplowitz

Thanks, guys.

Nicholas Gangestad

Thanks, Andy.

Operator

Our next question comes from the line of John Inch of Gordon Haskett. Please proceed with your question.

John Inch

Thank you. Good morning, everybody.

Michael Roman

Good morning, John.

John Inch

Good morning, guys. Mike, you opened the call talking about you, sort of, were positive – remain positive on a global macro. But I'm trying to understand, maybe, back to Andy's question, there are a degree of evidence, right, that electronics markets in Asia, maybe even China and China auto and so forth, are bottoming.

Why you would you take the 2,000 hedge action now? I mean, are you implicitly signaling that you actually don't think that there is going to be much of an improvement in the foreseeable future? Or is this kind of a catch-up from something you should have been doing before and you were just hopeful things were not going to kind of fall apart to the degree they have?

Michael Roman

Yes. John, so your point about the global macro is right. There is an expectation that there will be a broader growth in the global macro and maybe a bit slower as we come through the year in terms of global industrial production in particular.

In the markets that we're talking about, they certainly have been slowed. But people have a view that it gets better as we get into the second half. I think, to a degree it's realigning ourselves. The actions we're taking is realigning ourselves with what we see in the market and what we've been working through as we come through for sure, kind of, the end of Q4 or end of Q1.

If the markets recover, we – this is our playbook. When we see a slowdown, we realign our costs, we realign our operations, we take some targeted restructuring action and then we're in a good position to lead out.

So I think this aligns us with what we today, really what we need to do in order to deliver on our commitments and then positions us to lead out of it. And so, if we do see that improvement in the second half, we'll be well positioned to lead out, even with these actions that we're taking.

John Inch

In other words, you don't have to hire people back if things turn? Is that what you...

Michael Roman

No, I think, we're aligning ourselves as we go forward, taking advantage of some of the things that we're doing to – with business transformation to leverage that. So this is – it's never easy to do this. And it is – you're asking question around something that we think very hard about.

And I really am taking on very personally, we've got to think about what do we need to do near term and position ourselves for the long term. And we're going to continue to invest in growth into R&D and R&D growth programs and priority growth opportunities more

broadly.

So we're making sure to make this restructuring and realignment targeted to what we what we have to manage through. And so, will we need to hire people in the future? Yes, of course. As we go forward we will, where we see the opportunities and we'll invest. But in the near term, we've got to realign ourselves to be ready to deliver on those statements.

John Inch

Got it. I want to shift gears to PFAS. If you go by the K, the litigation over the past couple of years definitely seems to be rising. There's a lot of reasons that people have potentially thrown out. First, I want to confirm that you do not have insurance in any context to pay for any of these litigation costs. I think the 850 to Minnesota was paid out of cash, right?

And then the second thing is could you guys just give us a sense of what exactly is your playbook for dealing with this? Are you just going to litigate concurrently? Or are you going to try and bundle this and deal with it? I just -- it's hard to know from where we stand right why this isn't potentially an asbestos round two that unfortunately ended up bankrupting dozens of U.S. companies. And I don't think you're in that situation but anything you could say to that will be helpful.

Nicholas Gangestad

Hey, John I'll just start talking about insurance and then I'll pass it over to Mike for your broader question. In regards to insurance and coverage for that for environmental claim such as PFAS, we do have places where we think we have insurance coverage and we are in discussions with insurance carriers regarding those matters. But that's going to take time for that to play out, John. That's -- don't look for that in the short-term for something to happen on that front.

Michael Roman

Yes. And John just regarding the litigation activity. I mean, we are actively depending ourselves in all of this litigation. And it's difficult to know the timing and outcome of any particular litigation. And what we were able to do with the reserve this quarter is to really establish reserves that help us resolve the litigation that is related to environmental matters. And I would say litigation were a direct defendant around our manufacturing disposal.

As I said in my comments, it is not covering any other product related PFAS litigation. And when you have the manufacturing in view where it's probable and estimable, the product litigation at this point that were defending ourselves against is not probable an estimable. And so we will update as appropriate and as we get some clarity on that. So it's really -- there are two different aspects of it there that we're managing.

John Inch

Would it be fair to say this is going on for years. I don't see any a milestone event that potentially stops there. Is that a fair thing? It looks like the EPA is going to potentially come out with even more articulate regulations or guidelines or something like that.

Michael Roman

Yes, and we continue to work with the EPA and other regulatory bodies on the foundation for the regulations that are being talked about and what will come. EPA, of course, announced a management plan for this and we're working with them to support where we go forward there. We actually are supportive of a federal approach here so we don't end up with a state-by-state approach that's different or patch work kind of approach. But it is something that is evolving and we'll continue to help be part of that with the EPA. And like I said, we'll update you on our litigation matters as appropriate.

John Inch

Got it. Thanks very much. Appreciate it.

Operator

Our next question comes from the line of Julian Mitchell of Barclays. Please proceed with your question.

Julian Mitchell

Hi, good morning.

Michael Roman

Good morning, Julian.

Julian Mitchell

Morning. Maybe a first question for Mike. So just trying to think about the last few months at 3M. You had the outlook meeting in November with some medium-term goals. Then you had a sort of re-segmentation more recently, and then today restructuring alongside another guidance reduction.

So I understand that the restructuring and the guidance reduction, obviously, very closely linked. But I'm trying to understand what else has changed since that November meeting where it sounded like a case of steady-state high CapEx, high R&D the same segments.

Then we heard the segments being changed. Now, the CapEx commitment seems to be wavering per the CapEx cut this morning. So, maybe just talk us through more broadly how your own thoughts about running and organizing and managing 3M have changed in the past few months.

Michael Roman

Sure. And I'll go back to that in November Investor Day. I would say first of all, the realignment of the business group us was part of our thinking at that point. We weren't ready to announce it and implement it. There were things that we have to do to get ready for that. But it was part of -- even as I talked about, it's part of our expectations that will drive improvements of 200 to 300 basis points in our margin. And it really is set up to help us leverage best our business transformation and end-to-end streamline our connection to customers. So, it's part of the longer term strategy.

As we came into the year, as we walk through the quarter -- even as we came in, we certainly acknowledge that we're seeing slowing in some of those key end markets. It got more severe as we go to our earnings call -- in the Q4 earnings call in January. As we went through February, we saw additional slowing and we're talking about it.

And we were taking actions all along the way. We were doing things. We've been doing things along the way to adjust and address that slowing we are seeing, but we didn't get ahead of the curve. And so the restructuring and the other actions we're taking is to really do that now.

So, it is -- I would say it's still rooted in that five-year plan and our commitment to investments and growth in R&D and the strategies that we talked about there is still very much part of it. The 3M model is strong. We've got to near-term execute and get in line with what we're seeing in these end markets.

And that became kind of the new, I would say, set of actions that we had to step into and we're doing that. But again we know how to execute this playbook. We'll be rallying the team around us as we go through the next couple of days and I'm confident that we will step into it as we go ahead.

Julian Mitchell

That's helpful. And then my second question maybe around any updated thoughts on the portfolio. Should we view the re-segmentation as opening the door to any divestments? Does the guidance reduction make you think that maybe more portfolio pruning is needed?

And on the other side of the ledger, should we expect more acquisitions now that M*Modal has closed? Or is it more of a case of there are some internal things to fix, let's fix those first and think about M&A maybe next year?

Michael Roman

Julian I'll start here as I always do. Organic growth is our first priority. So, we're going to continue to focus investments there as I said even as we go through this restructuring. But we still maintain flexibility to invest in the long-term value of the enterprise. And so acquisitions we have built strong capabilities to make acquisitions that fit with our fundamental strengths that fit in our most attractive markets.

And we've been executing that. We still see that as a value driver for us in the future. And so we continue to stay active looking at acquisitions. We're going to continue to step into compelling acquisitions that leverage that strategy and capabilities that we have to create value.

On the divestiture side, we've been actively managing a portfolio since 2012. And over the last three years, we've strengthened parts of our portfolio. It was a case we're always looking at how do we maximize the portfolio. And we're looking at businesses regardless of size on how we do we do that and how do we maximize value for the company and it's really around the fit with our fundamental strengths and we'll continue to actively manage it as we go forward. It's an ongoing process and we'll be focused on creating value with that as well.

Julian Mitchell

Great. Thank you.

Operator

Our next question comes from the line of Josh Pokrzywinski of Morgan Stanley. Please proceed with your question.

Josh Pokrzywinski

Hi. Good morning, guys.

Michael Roman

Good morning, Josh.

Josh Pokrzywinski

Just on the comment on inventory destocking, Mike and Nick, do you have a sense for what that might have cost you in the quarter?

Nicholas Gangestad

Josh, so for the quarter we still built inventory.

Josh Pokrzywinski

I mean, your customer's destocking. I'm sorry.

Nicholas Gangestad

I'm sorry. I think it very easily could have impacted our total revenue by 100 basis points.

Josh Pokrzywinski

Got it. That's helpful.

Michael Roman

Josh just to give you a little color too. The automotive slowdown in China was one particular case where we saw significant impact in our growth from channel. And so where you see a slowdown in a particular market, like electronics or automotive it's accompanied with a change in inventory, everything from finished goods back through the value chain. And so that is a – that's clearly visible in those cases.

Josh Pokrzywinski

Got it. And then just pivoting back to an earlier question on some of the PFAS litigation, as a non-attorney this is maybe more obvious to other folks than myself. But given that you already have kind of one fight example in Minnesota with an 850 settlement. Is there a reason why adding the other four in there might not just be 850 times four. Is it kind of a easily digestible answer? Or is it a lot of hey it depends and there's a lot of differences?

Michael Roman

Well, our manufacture footprint is different in every one of those sites and so that's part of it. But it really – I guess, if you can take from this is, it's not simply that – not simple math of multiplying times five. We've – we now define probable and estimable for the litigation that we face in those five sites as – with this reserve. So that is our – the way we have had determine what is estimable across that.

Josh Pokrzywinski

Got it. Thanks for that. And then just one last one on some of the re-segmentation. I understand this is not the quite the same thing as ERP was last year. But could we expect some sort of disruption to the customer side with some of the restructuring and re-segmentation being implemented? Thanks.

Michael Roman

The realignment of the businesses is really – really the key focus for us was the customer and really aligning to them aligning to the customer segments and the type of customer and the go-to-market model. So we are actually – we've been moving towards this with some of the go-to-market model, capabilities that we've been putting in place and the way we leverage Business Transformation. This actually steps it forward even more. So I think this is not only focused on the customer I think the customers will see this as a positive step forward. And we'll see it as better aligned to them as we globally as we move ahead.

Josh Pokrzywinski

Okay. Thanks Mike.

Operator

Our next question comes from the line of Deane Dray of RBC Capital Markets. Please proceed with your question.

Deane Dray

Thank you. Good morning, everyone.

Michael Roman

Hey, Deane.

Deane Dray

Hey, I missed the very beginning intro comments. And we've touched on this channel inventory adjustment topic a couple of different times, with Josh's question just then. But can you just clarify how much was any kind of 4Q pull-in getting ahead of tariffs, getting ahead of price increases? And maybe you also had some of this ERP pull-in as well. How much of a factor is that in terms of this inventory adjustment?

Michael Roman

Yes Deane we talked about a bit on our Q4 call. We saw the channel as well as balanced as we came into the year. We didn't see a pull-ahead in Q1 into Q4. The ERP impacts were largely Q2/Q3; we saw some tail of that into Q4. And it's hard to tell there may be a small tail as we come into this year as well which would be more playing out of some inventory. But that's a U.S. kind of view.

The -- when I look at it, even as we went through the quarter, I would say Health Care channels are well balanced. We certainly saw our balance between sell-in, sell-out, and consumer. It was the Electronics and Automotive driven changes that really led to the channel impact. And maybe a few pockets in Safety and Graphics in areas like transportation where we had some project delays. But the bigger was in the Industrial and Electronics areas. So, that developed as the quarter went along and the response was very, very direct and we saw that in Q1.

Deane Dray

Got it. And then on -- to go back to your comments about the lag in realigning your cost with the lower demand through the quarter. It would be interesting hearing from you about what was different about your response time. Is this -- just -- is this inherent to the 3M short cycle business? You just don't have that visibility; so therefore, you can't ramp down the cost structure that quickly. Does that put you at a disadvantage here in terms of the responsiveness? When you I look at decrimentals, companies that can ramp down costs quickly, typically will see a 25% decremental and you're well lower than that. So, it look like it did get away from you, but some color there will be helpful.

Michael Roman

Yes. Deane we did take actions as we saw slowing growth. We're reducing production plants, we're adjusting demand plan. And we're trying to look ahead as much as we can into our customers get a clear view. And I would say in the direct businesses, we got a pretty clear view. It was a matter of how fast can we react. And we took actions in the end our volume that we produced went down in line obviously with our organic growth, but our costs didn't. And that was one of the challenges. And some of that is fixed cost some of that is variable costs and we need to do something on both of those.

And so that's where the restructuring is targeting that. And that's not unusual in these situations in the industrial slowdown in 2015-2016; I face the same thing in leading that business and even in 2009. We have to take restructuring actions to really step into a bigger slowdown and in most particular markets that's what is taking here. And so the steps we took now we'll get ahead of the curve.

Deane Dray

Got it. Thank you.

Operator

Our next question comes from the line of Scott Davis of Melius Research. Please proceed.

Scott Davis

Hi, good morning guys.

Michael Roman

Hey Scott.

Scott Davis

Hi. I want to change gears a little bit because I think the -- I think most people at this point kind of get the issues. But I want to talk a little bit about R&D productivity and payback because just back the envelope, I don't think 3M historically has outgrown the Industrial group, in fact, it seemed to have undergrown some of the higher end peers out there and certainly spent a lot of money on R&D. Obviously there's a higher margin structure that is supported by that. But how do you fix that? How do you get the growth rate to really accelerate from these levels, which are really, basically just GDP type levels over time over really almost any time period you look at?

Michael Roman

Yes, Scott, so you're right. Our investment in R&D and I would say innovation more broadly is fundamental to what we promised our investors and that is strong growth. Growth that outgrows the macro over our business cycles and deliver premium margins, deliver premium ROIC. And innovation is fundamental to that. In fact, it's the differentiator in our ability to do that. And I think in a quarter like this and even the cycle that we've been going through it's right to challenge our growth aspect of that. And what we are doing is really focused on that as well.

And I would say this our capacity and our demonstrateability outgrow the macro over time has come from two important factors. One is our investment in innovation. Our ability to deliver new penetration opportunities with our innovation, new priority growth platforms as we talk about. And so those are very much a focus for us. It's also important that we do that in markets that are accretive to the macro that we're choosing. And that's our portfolio management. Make sure we're prioritizing in the most attractive market spaces.

And so that is -- we often talked about the priorities organic growth in our capital allocation approximately 6% to sales and R&D and 4%, 5% to 5.5% in CapEx. But we prioritize that. It is really important that we prioritizing that and that's what we do to get that growth where we needed to be. And we did it in markets in that are most attractive. That's the focus. That’s when I talk about continuing to invest in growth that's what I'm talking about.

Scott Davis

Fair enough Mike. And when every add, I mean, you've been on board now you're not brand-new, but you're relatively new I think in comparison to many CEOs. And do you think you need to change the compensation scheme at all? Or is there something that as far as getting incentives more aligned with faster execution, because and I don't mean this to be mean. But if you go back really think about the 20 years or so I've covered your stock. 3M always seems to be a little bit behind on the restructuring curve almost never ahead. And even if you get this one right you're still behind. So do you need to change anything around the incentives or compensation scheme to get some of your leaders to move a little faster?

Michael Roman

I think compensation is an important part of this. And we've updated and modified our compensation over time to do just what you're talking about to really align our leaders with what we need to deliver. And in particular, our promise to our investors, our organic

growth, our EPS growth, our ROIC, our free cash flow. That is how they're aligned. They are aligned to the four promises. And were we -- should we take another look at that? I would say that's our normal course for us. We're going to take stock of what we're doing, how we're doing it and compensation is an important piece and we look at that as well.

Scott Davis

Okay. Good luck guys. Thank you.

Operator

Our next question comes from the line of Laurence Alexander of Jefferies. Please proceed with your question.

Laurence Alexander

Good morning. So, just wanted to touch on two things. First, is there -- as you think about the -- when I think about the call -- you talked about the -- this kind of sequencing, it's usually a multi quarter episode, I mean I'm thinking about like the way you slice it down [indiscernible] a few years ago. Can you just be clear, have you seen any actual churn in your order patents? Or is it just affects of sequential stabilization?

Michael Roman

Lawrence, I mean you broke up a bit, so I'm not sure I got a question. But I think you're asking about the softening and the slowdowns that we're seeing. They can sometimes last longer. Do we see any indication that those are turning or not expected last long, is that the kind of…

Laurence Alexander

Right. Did you see – have you seen any actual turns in order patterns? Or is it really just more -- everybody's forecasting the back half therefore?

Michael Roman

Well, I would say we haven't seen a sharp turn in softening markets. We're in line as we go into April with our expectations. I would say maybe we see that the inventory adjustments slowing down. I mean, those don’t tend to be fourth quarter unless there's another macro event that drives it. Those will adopt pretty quickly. That -- and we're seeing maybe some signs of that as we go forward. But we certainly don't see what these

particular markets automotive electronics. They're forecasting, a stronger second half and we don't see the early indication of that yet. I think it makes sense to a degree what they're talking about, but not early days of April have we seen that.

Laurence Alexander

And then just secondly on the litigation side. How much have you -- have you done a full scrub of the exposures? I mean, when you have a scientific -- culture scientific debate sometimes the debates look different after the fact. So have you gone through and just scrubbed the way the debates were handled within the firms so that there's no surprises as the litigation proceeds?

Michael Roman

Lawrence, I would say this is a top priority, an issue for us as an enterprise and we are taking it with that in mind. And we have -- we formed a corporate affairs organization as part of our business realignment. Really it brought together a lot of the people that are working on this among other issues because there's broader brand and reputation strategy that they are focused on. But we have -- we've invested in I think a bigger capability around how do we look at it, how do we manage it, and how do we -- how we really take our brand reputation and take that forward as a company. So the answer is we are stepping up to it. It is emerging issue that has certainly gotten bigger as we went through the last year. And I would say we're stepping into it with every capability and with a lot of good counsel as well.

Laurence Alexander

Thank you.

Operator

Our next question comes from the line of Steve Tusa of JPMorgan. Please proceed with your question.

Steve Tusa

Hey, good morning.

Michael Roman

Good morning, Steve.

Steve Tusa

So when I look at the annual bridge on EPS, I think you guys this year were planning on about $0.30 to $0.40 from transformation productivity and pension tailwind. Are you -- are those still isolated items? Are those still on track?

Nicholas Gangestad

Yes. Steve, the pension impact, the underlying business transformation productivity, the footprint action savings, those are all on track. But with the lower growth, the two things changing lower growth and all other productivity, those are the two components that are bringing that that part down, as well as the charge that we're anticipating in Q2 for the restructuring actions.

Steve Tusa

Okay. Yes. And that entire charge is coming in Q2. You're going to take that or run that through EPS?

Nicholas Gangestad

We think the majority of that – it could be all of it, but we think the majority that will be in there.

Steve Tusa

Okay. Can you just give us a little bit of color on what you kind of expect now for margins? Whether it's second quarter, the year, I mean, the more detail the better it is, so we call all kind of calibrate and reset ourselves from this level, operating margins.

Nicholas Gangestad

Yes. Steve, when we take into account our recent acquisition of M*Modal, when we take into account this restructuring charge, we are seeing margins down likely 100 basis points for the year, with those two items contributing just over half of that total decline in the margins.

And that's different, where, from a three months ago, saying we were expecting margins to be up. The core underlying productivity, even with these actions we don't think it's going to be accretive to our margins yet this year. We think that will come later.

Steve Tusa

Right. And one last quick one. So you mentioned Minnesota on the PFAS stuff. I thought you guys already took a charge for Minnesota. Was that – are you saying, we already took that charge, so we're just reminding you of it? Or was there an incremental charge in Minnesota?

Michael Roman

Yes. Steve, it was -- I would say, a bit of a reminder. But it was – just to let you know, this encompasses those facilities. There is – there was a small part of it that just – is part of Minnesota as we look ahead. But it was – the 850 was the majority – the vast majority of what we faced in Minnesota.

Nicholas Gangestad

Yes. That charge -- the 850 is the last year, Steve.

Michael Roman

Yes.

Steve Tusa

Yes. No, no. I was just – I'm trying to, kind of, like, I just – I don't know whether the – I thought the 850 kind of ring-fenced it, for a lack of a better term. So the fact that there's kind of another charge in Minnesota, I'm just trying to kind of – I definitely haven't done – I'm not a lawyer, I don't know how to work on this. So I thought kind of the 850 took care of Minnesota.

Michael Roman

Yes. And that's the way to think about it, Steve. We…

Steve Tusa

Okay.

Michael Roman

This was just to make it complete, so that we didn't leave Minnesota out and then have it kind of question by exception.

Steve Tusa

Yes. Okay, great. Thanks a lot, guys. Thanks for detail.

Operator

Our next question comes from the line of Nigel Coe of Wolfe Research. Please proceed.

Nigel Coe

Hi. Thanks. Good morning, guys.

Michael Roman

Good morning, Nigel.

Nigel Coe

Yes. Hi. I just want to pick up on Steve's point there. What was the trigger point to make this NRD charge probable and net submitable? I know there was a ruling in New Jersey. Was that the sole trigger point? Or was there something else that we're missing?

Michael Roman

With the NRD I think really what you're talking about Nigel is a year ago. I think what you're really asking is, what's the triggering point for us to be taking this charge now in the first quarter. And we've been working on that with a number of the parties, where we have litigation going on.

And we reached a point where we felt that based on the progression of those, the facts on those cases and where we stood with potential settlements, we actually did have some settlements occur in first quarter, which gave us better visibility in how to estimate more broadly across all our manufacturing sites, what we see is our liability.

Nigel Coe

Okay.

Michael Roman

And by the way…

Nicholas Gangestad

The New Jersey is not one of the places where we manufacture. That's a different lawsuit related to the use of the product and not related to our five manufacturing sites Nigel.

Nigel Coe

Okay that's great. And then just one quick one on kind of two key setup. You talked about maybe 100 basis points of channel, you've got the selling day headwind moves away 1Q to 2Q, but then we've got a type of comp about two or three points. Would you expect to have [ph] that 2Q would remain sort of in this low single-digit decline range?

Nicholas Gangestad

Nigel, it would not surprise me if we were looking at negative organic growth in the second quarter.

Nigel Coe

Okay. Thanks guys. Good luck.

Operator

Our next question comes from the line of John Walsh of Credit Suisse. Please proceed with your question.

John Walsh

Hi. Good morning.

Michael Roman

Hi John.

John Walsh

I guess maybe just to follow-up on Nigel's question about that point of inventory. Does your guidance assume that that comes back i.e., there is some refill at some point in the year? Or is that contemplated as just these inventories are now going to remain where they are for the balance of 2019?

Michael Roman

Yes, John it's really is the latter. So it's more a model of that remains. For inventory to come back there we would have to be a noticeable upturn in the market and that with some of the outlook for the second half that could be possible, but that's not what we're looking at. We're looking at the adjustment down levels out and we manage at that level as we go through the year.

John Walsh

Got you. And then I guess can you give us an update on, there was a lot of focus at the Analyst Day on this $1 billion sales bucket of priority growth platforms. Can you give us an update of what they did in the quarter?

Michael Roman

John, we'll update you maybe in more detail as we go forward. We saw very good progress across those priority growth platforms. There are two things that we measure. One is the revenue and the second is, are we making progress in the milestones so the product launches and the specifications. And you take automotive electrification and we saw significant wins in Q1 and new spec in business and we continue to see strong upper single double-digit growth even in that portfolio. And I would say across the businesses this has been one of the bright spots. When you look at quarter like this, there is a lot of challenges and it's disappointing, but there are some businesses and some bright spots and we had good business performance in our existing portfolios and we've certainly would count our priority growth platform as one of the positive contributors to growth and new products more broadly. But those priority growth platforms are even stronger. So we – I'm pleased with where we are. We're tracking to our plans and we can update individual programs when we talk to you.

John Walsh

Okay. Thank you.

Operator

This concludes the question-and-answer portion of our conference call. I will now turn the call back over to Mike Roman for some closing comments.

Michael Roman

Okay. Thank you. To wrap-up, we are moving with urgency and taking action to strengthen our performance in 2019, while investing for the future. I remain, confident in the world-class capabilities of our enterprise and in our 3M model. We know we have to rebuild our credibility. I'm confident we will get our performance back in line with the expectations of our investors. Thank you for joining us.

Operator

Ladies and gentlemen, that does conclude the conference call for today. We thank you for your participation and ask that you to please disconnect your lines.

Comments (2)

Daniel Cluley
YIKES!

09 May 2019, 10:11 PM

Deleted 435456
I'm sure it has had it's bad moments in this 60+yrs of div increases so....

03 May 2019, 01:14 PM